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Under the placid surface, there are disturbing trends: huge imbalances, disequilibria, risks — call them what you will. Altogether the circumstances seem to me as dangerous and intractable as any I can remember, and I can remember quite a lot. What really concerns me is that there seems to be so little willingness or capacity to do much about it...

We are buying a lot of housing at rising prices, but home ownership has become a vehicle for borrowing as much as a source of financial security. As a nation, we are consuming and investing about 6% more than we are producing.

What holds it all together is a massive and growing flow of capital from abroad, running to more than $2 billion every working day, and growing.

— Paul Volcker, "An Economy on Thin Ice," *The Washington Post*, April 10, 2005

TURNING POINT

It can no longer be doubted that the world economy is heading into a new downturn following a recovery that has been unusually short and weak among the industrial countries. The loss of momentum during the second half of last year was especially pronounced in Japan and several Far Eastern countries. In Europe, the major eurozone economies have been making headlines for some time with very unpleasant growth and employment numbers.

There seemed to be two great exceptions to this unfolding general economic slowdown: the United States and China. That, at least, has been the overwhelming perception. A strengthening dollar largely reflected the consensus view that the growth spread between the United States and the eurozone would considerably widen again, as the U.S. economy maintained its strong growth.

At a conference of the Federal Reserve Bank of San Francisco on April 14, Fed Governor Donald L. Kohn presented a cheerful picture of the U.S. economy, starting his speech: *"The economy has been performing well of late. Economic activity has shown a good bit of forward momentum as businesses have stepped up their purchases of capital equipment and households have continued to increase their spending on consumer goods and services and on houses."*

Further fuel for the new dollar bullishness arose from the expectation that gradually accelerating inflation would induce the Fed to step up its rate hikes further. In its earlier comments, the Fed's Federal Open Market Committee has done its best to confirm these high-riding expectations about the economy.

As we have explained in detail many times, we radically disagree with this general unconcern about the U.S. economy. Its stellar aggregate growth rates, particularly since 2000, have masked a dramatic deterioration in the four key fundamental determinants of long-term economic growth: national and personal savings, productive capital investment, profits and the current account of the balance of payments. All four are in shambles.

In essence, recessions are the phase in the business cycle in which consumers and businesses unwind the borrowing and spending excesses of the prior boom. In the U.S. case, the ugly reality is that the excesses and imbalances of the boom years in the late 1990s have grown in the past few years to extremes unprecedented in history.

The big question now is whether the rosy assessment of the U.S. economy is right or wrong. In our view, it

is dead wrong, for two main reasons: *First*, contrary to perception, the flow of economic data since the beginning of the year suggests the exact opposite; and *second*, and more important, the U.S. economy's recovery from its recession in 2001 has a precarious foundation in the unsustainable housing bubble and exploding consumer debts, while employment and income growth are calamitously lagging.

While scrutinizing the economic data, we first noted a sharp slowdown in consumer spending. Inflation adjusted, it declined slightly in January, by 0.1%. An increase of 0.3% followed in February. Meanwhile, sluggish retail trade figures for March suggest little more than stagnation. With these weak numbers before our eyes, we have been following the public discussion and the Fed's statements about the strong economy with amazement.

AN OMINOUS PARALLEL

All this has reminded us of a similar experience in 2000. For us, there is an ominous parallel. In the consensus view, the U.S. economy continued to boom. Taking everybody — including the Fed — completely by surprise, the share market and the economy went into a sudden sharp slump, while the Fed kept raising interest rates in order to fight inflation.

We see today the very same uncritical complacency about the U.S. economy. Although its recovery from the 2001 recession has been, by any measure, the weakest by far in the whole postwar period, people are beguiled by juxtaposing the apparent strong U.S. economic growth with a sluggish Japan and Europe. At the same time, we are pondering a question that is, unquestionably, the most important of all: Is today's U.S. economy in better or worse shape than in 2000?

First, though, back to 2000. On the morning of Feb. 2, the Fed's senior economists started a meeting of the FOMC with a review of recent developments, which confirmed that the economy was still growing strongly. During the policy discussion, the only issue of contention was how far to raise the federal funds rate. Some members of the committee wanted an immediate half-point increase in order to signal the Fed's determination to get a grip on the booming economy.

After lunch, the Fed announced a rate hike from 5.5–5.75%. In a statement, the FOMC said it remained *"concerned that over time, increases in demand will continue to exceed the growth in potential supply, even after taking account of the pronounced rise in productivity growth. Such trends would foster inflationary imbalances that would undermine the economy's record economic expansion."*

On March 21, 2000, the FOMC discussed another rate hike. The consensus saw no sign of an economic slowdown. Consumer spending remained particularly strong. Again, there was a unanimous vote to increase the federal funds rate to 6%. Repeating the formula used after its previous meeting, the committee said, *"The economic risks weighed mainly toward conditions that may generate heightened inflation pressure in the future."*

Percent Changes From Preceding Period in Real Gross Domestic Product (Seasonally adjusted at annual rates)

	1999	2000				2001	
	IV	I	II	III	IV	I	II
Real GDP	7.3	1.0	6.4	-0.5	2.1	-0.5	1.2
Consumption	5.0	6.5	2.5	3.9	3.4	1.7	1.0
Fixed Investment							
Nonresidential	1.0	14.3	14.8	2.2	0.9	-4.2	-13.6
Residential	5.0	4.1	-3.5	-8.0	0.4	2.2	5.6

Source: Bureau of Economic Analysis, Survey of Current Business

The third rate hike followed on May 16, 2000. According to the published minutes, the economy was still seen to be powering ahead. Even though stock prices were sliding, the Fed raised its federal funds rate by 50 basis points, from 6% to 6.5%.

In fact, real GDP inched up during the first quarter by just 1% at annual rate, following a 7.3% jump in the prior quarter. While the second quarter sparkled again with a high growth rate, an abrupt slump of fixed residential and nonresidential investment pushed real GDP growth in the third quarter into negative territory at minus 0.5%. In hindsight, the boom clearly broke in early 2000, when the Fed still saw nothing but a continuous boom requiring higher interest rates. Just look at the data on the previous page.

Just seven months after its 50-basis-point rate hike in mid-May 2000, the Fed started its most rapid and drastic rate-cutting binge in history to prevent a slumping economy and a collapsing stock market from hurtling the economy into a dreaded deep and long recession.

Looking at the very weak first quarter of 2000, the third rate hike by 50 basis points in mid-May is particularly hard to understand. Moreover, the equity market had been sliding since March. That a central bank would tighten the reins in the face of a crashing stock market was definitely unusual. But in its associated statement, the FOMC justified its decision with *"extraordinary and persistent strength of overall demand."*

In other words, they had no inkling of the rapidly spreading weakness in the economy. It reminds us of a famous remark by Joseph Schumpeter about events in 1929: *"People stood their ground firmly. But that ground itself was about to give way."*

Yet the Fed had one apparent excuse for its false optimism in early 2000. It is apparent in the following table. According to Bureau of Economic Analysis data available at the time, real GDP growth had soared by 5.4% at annual rate in the first quarter, as against the later downward-revised rate of just 1%. Still, the early slide in the stock market, which started in March 2000, suggests on its part a far better "smell":

Percent Change of Real GDP, as Originally Reported

	1999	2000				2001	
	IV	I	II	III	IV	I	II
Real GDP	8.3	5.4	5.6	2.7	1.0	1.2	.7

Source: Bureau of Economic Analysis, Survey of Current Business

We have recalled this episode because it seems to us a striking parallel to the present experience. In contrast to the bullish consensus view, we see many signs and problems in the U.S. economy that suggest an impending sharp slowdown.

For most economists, economic analysis today is little more than the simple extrapolation of the economy's most recent growth rates. Economic growth in 2005 must be strong, because it was strong until late 2004. There is literally zero public discussion about the future implications of rock-bottom savings, skyrocketing levels of unproductive debt, a massive budget deficit and a soaring trade and current account gap. This takes us to the main issue about the U.S. economy — its long-term viability.

CARRY TRADE SETS THE LIMITS TO RATE HIKES

Although the Fed has moved its federal funds rate from 1% to 2.75%, its speakers, and Alan Greenspan himself, keep emphasizing that "easy money" is still in place. In his congressional testimony on Feb. 16, 2005, Mr. Greenspan said, *"The cumulative removal of policy accommodation to date has significantly raised measures of the real federal funds rate, but by most measures, it remains fairly low."*

The official target is to raise the Fed's federal funds rate to a "neutral" level. Although Mr. Greenspan has admitted not to know where that rate is until he gets there, there seems to be a general assumption that it implies sustainable economic growth with price-level stability. Where could that rate be in the U.S. case?

We have learned that the inflation-adjusted federal funds rate has averaged around 2% over the postwar period. Given a present inflation rate for consumer prices of around 3%, this would put the "neutral" nominal federal funds rate presently at close to 5%, plainly far above its current reading of 2.75%.

To be sure, nobody in the Fed is seriously eying this rate. They are undoubtedly fully aware that a short-term rate at this level would definitely pull the rug out from under the whole U.S. financial system.

The crucial point to keep in mind is that America's present high level of asset prices has its foundation not — as is normal — in available savings, but in highly leveraged "carry trade," the extensive practice of financial institutions to ride the yield curve by borrowing short at low rates to buy higher-yielding assets, mainly longer-term bonds.

By holding U.S. short-term rates at artificially low levels and also making unlimited liquidity available, the Fed has driven the carry trade to unprecedented extremes in history. The desired result was artificially low long-term interest rates to fabricate the housing bubble. But as short-term rates rise, the carry traders get squeezed. Implicitly, there comes a point when they are forced to liquidate their leveraged positions.

However hawkish the Fed's talk about fighting inflation may be, the monstrous carry-trade bubble is setting narrow limits on any further rate hikes, regardless of what may happen to consumer price inflation.

To put it briefly and bluntly, the Fed is no longer in control of its interest rate instrument. Considering the threat of collapsing carry trade, it would surprise us if they dared to move the federal funds rate above 3.5%, though this might barely match the current inflation rate.

With 20 times leverage, or just 5% equity, as the virtual norm in bond carry trade, a rise in the yield of 10-year bonds by just one percentage point would more than wipe out the whole underlying equity.

Judging from past experience, we presume that the Fed's hawkish tone about fighting inflation through faster rate hikes has the purpose of precisely preventing the need for such action by assuaging the markets.

THE MYTH ABOUT THE "NEUTRAL" INTEREST RATE

This brings us to the Fed's declared intent to aim for a "neutral" rate of interest, as propagated by Swedish economist Knut Wicksell (1851–1926). According to Fed officials, Mr. Wicksell's idea of a "neutral" interest rate exerting no inflationary influence captivates them. As he put it in 1898, *"There is a certain rate of interest on loans which is neutral in respect to commodity prices, and tends neither to raise nor to lower them."*

But in contrast to today's Fed officials, Wicksell had a precise notion of how this noninflationary rate of interest comes about: *"The rate of interest at which the demand for loan capital and the supply of savings exactly agree... will then be the normal or natural real rate."*

Interpreting Mr. Wicksell correctly, the neutral, or natural, interest rate is a rate that restricts the current expansion of credit to available domestic savings and secures the stability of the price level. In other words, it is the interest rate that maintains equilibrium between credit and saving. That is really Wicksell's key point.

The basic idea behind this equation is that credit expansion has to absorb the part of GDP that savers release from consumption — no more, no less. But the Fed, referring to Mr. Wicksell, is turning his idea upside down by suggesting that a low inflation rate is proof of a "neutral" interest rate, justifying unlimited credit expansion. This is a scandalous misinterpretation.

It used to be elementary knowledge in economics, in fact, that "credit excess" means a credit expansion in excess of available savings. By this measure, the whole U.S. financial system represents nothing but credit excess. In 1995, there was a total credit expansion of $1,131 billion, compared with national savings of $306 billion. In 2004, a credit expansion of $2,718 billion occurred, with available national savings of $133 billion.

In 1995, the credit expansion was four times available savings; in 2004, it was more than 20 times. This is a preposterous development from the perspective of monetary equilibrium.

In fact, for years, the Fed has been systematically abusing the recorded low U.S. inflation rates to engineer and allow credit excesses of unprecedented magnitude in history, while domestic savings collapsed.

For us, the U.S. Consumer Price Index long ago became a red herring as a measure of inflation. Consider that in the third and fourth quarters of last year, the U.S. GDP price index rose a ridiculous 1.4% and 2.3% respectively at annual rate.

NOTHING BUT UNPRODUCTIVE DEBT

Our strong objection to the popular, narrow focus on the Consumer Price Index as the key measure to consider for monetary policy, though, has another important reason behind it. Depending on changes in the purposes of borrowing, the effects of credit excess on the economy and its price system may vary tremendously.

Until the 1970s, it made sense to focus on the price indexes of goods and services as the decisive measure of inflation, because ongoing credit growth centered on this kind of spending. Since then, however, literally exploding credit excess had its main outlets in the huge imports surplus and in the asset markets. Consumer price inflation became a drastically shrinking part of escalating overall inflation. Being, moreover, heavily manipulated to the downside, the low rate of inflation for goods and services was the convenient pretext for the Fed to keep the floodgates of money and credit wide open to fuel asset price inflation.

Wondering about the use of the trillions of dollars borrowed every year in the United States, we see one culprit being flatly ignored and never mentioned: exploding compound interest. Actually, there is no statistic to capture it. But with a little logic, a reasonable guess is easily possible.

Consider that total outstanding debt in the United States at the end of 2004 amounted to $36.2 trillion, up by around $10 trillion, or a stunning 38%, since 2000. How big is the annual interest bill on this amount? Assuming an average interest rate of 4% on these debts, the annual bill is $1.44 trillion; assuming an average interest rate of 5%, the annual bill is $1.8 trillion. Over the same four years, nonfinancial debt alone has surged by $6 trillion, to $24.2 trillion, implying a current annual interest bill, at 5% interest, of around $1.2 trillion.

The stunning surge in interest charges compares with total available national income now slightly above $10 trillion, with an increase of about $500 billion in 2004. There is plainly only one way to service this eruption of debts without a sharp reduction of current expenditures: paying debt service with new debt. Implicitly, compound interest is on a vertical rise.

The key point to see about the U.S. economy is that the ongoing credit explosion is financing a lot of different things, except production and tangible capital formation. Net fixed business investment has collapsed. Debt growth is almost entirely used for unproductive purposes, such as consumption, imports, government deficits, purchases of existing assets and financial speculation.

One of the unpleasant results of this massive shift in the use of credit is that it takes more and more debt to generate a unit of GDP growth.

A RECOVERY WITHOUT STAYING POWER

The most pressing question at this juncture, of course, is whether the U.S. economy has entered the crucial stage of self-sustaining growth. Plainly, this has been the consensus view until very recently. Add to this the Fed's hawkish comments about fighting inflation, implicitly suggesting a firming economy.

To us, in contrast, the signs are clear that the economic recoveries in the industrial countries from their lows in 2001 have passed their peak. In the case of Europe and Japan, the evidence has appeared compelling for some time. The International Monetary Fund lowered its 2005 eurozone growth forecast to 1.6%, against 2% last year. For the consensus, the U.S. economy is the great exception among the industrial countries, delivering further strong growth.

As to the U.S. economy, it was always understood that for sustained, strong growth, it would be essential

for Corporate America to "take the baton" on spending from the consumer. But that is definitely not happening. Instead, as pointed out, consumer spending is sharply slowing. On top of this, there is the worsening drag from the soaring U.S. trade deficit.

Lacking the normal strong support from labor income growth, the American consumer has instead exploited his inflationary gains from rising house prices as collateral for an unprecedented borrowing binge. How much of such home-equity extraction has been going on?

Here is our calculation: In 2004, new consumer borrowing amounted to $1,017.9 billion, up from $839.4 billion in the prior year. Net new borrowing on mortgages was $884.9 billion, or 87% of the total. Spending on residential building increased $91.1 billion, to $663.4 billion. This means that the vast bulk of the net new-mortgage borrowing binge was available for discretionary spending.

Consider that the disposable income of private households grew $482 billion during the year, while debts surged by $1,017.9 billion. Over the four years since 2000, the disposable income of private households grew $1,440 billion. This compares with a stunning increase in their indebtedness of $3,246.2 billion. It surely does not require particular intelligence to realize that this is an unsustainable development.

JUST DENIAL

A bubble economy implicitly accumulates two growing problems: debt excesses and structural distortions. The most striking, and most important, features of the structural distortions in the U.S. case are the virtual abolishment of domestic saving and the exploding current account deficit. Generations of policymakers and knowledgeable economists would have been horrified by such macroeconomic self-destruction. In today's America, they cause no more than a yawn.

The March/April issue of *Foreign Affairs* starts with an article titled *"The Overstretch Myth,"* subtitled, *"How We Learned to Stop Worrying and Love the Current Account Deficit."* Put briefly and bluntly: *"Chronic current account deficits reflect strong economic fundamentals rather than fatal structural flaws."* In short: The U.S. current account deficit is healthy, sustainable and desirable, and its size does not matter.

What the two authors express is apparently the consensus view among U.S. policymakers and established economists. Among the latter, there is just one solitary voice of warning, that of Stephen Roach of Morgan Stanley. We realize that Wall Street economists have limits to expressing concern about the economy. What astonishes us is that even independent economic academia keeps wrapped in silence. Why?

Our cursory answer is shocking: They do not know better. Macroeconomic analysis — the study of the economy as a whole — is traditionally a blind spot for American economists. On Wall Street in particular, all thinking is dominated by the micro view of what is happening to the individual firm or household.

From this perspective, what is good for the individual firm must also be good for the economy as a whole. If a huge surplus of cheap imports is good for the American consumer, it must, according to this logic, be good for the economy as a whole. It is as simple as that.

ECONOMICS WITHOUT THEORY

We come to a second shocking statement: Most American economists grossly lack macroeconomic theoretical knowledge. This goes back a long time, to professor Wesley Mitchell (1874–1948), who may be regarded as the doyen of American economic science.

In 1913, he published a voluminous book, *Business Cycles*, in which he declared that the study of business cycles must be a *"descriptive analysis of the cumulative changes by which one set of business conditions transforms itself into another set."* Looking primarily for statistical regularities in the business cycle, Mitchell neglected to search for two important things: *first*, causal influences and processes; and *second*, major departures

from the regular cyclical path.

In 1924, Friedrich Hayek, the great Austrian scholar, undertook his first visit to the United States. On his return, he published an extensive essay on U.S. monetary policy after the recovery from the 1920 crisis. In this paper, he expressed his amazement about what American economists regard as "research":

> *They do not begin from a definite basic theoretical conception of the economic process, but content themselves with gaining as detailed as possible a picture of the typical course of the cycle with the aid of detailed statistical investigation of the behavior of the individual factors in each phase of the cycle… The result is a type of symptomatology of the course of the cycle.*

In his *Monetary Theory and the Trade Cycle*, Hayek emphasizes: *"On the whole, one can say without exaggeration that the practical value of statistical research depends primarily upon the soundness of the theoretical conceptions on which it is based."*

CONFUSION ABOUT SAVING

America's two most striking and also most damaging structural imbalances, as already mentioned, are the collapse of domestic saving and the exploding trade deficit. Yet policymakers and economists generally just shrug their shoulders about them. From their arguments we must conclude that they lack any understanding of these tremendous destructive effects on the economy implicit to these huge imbalances. Strikingly typical of this broad macroeconomic ignorance is the widespread belief that rising asset prices should be treated as wealth creation or saving.

When speaking of saving, it is necessary to distinguish strictly between two different perspectives: *first*, macro versus micro terms; and *second*, physical and financial resources.

Here is a precise definition by E.A. Goldenweiser, director of research for the Board of Governors of the Federal Reserve in the 1920s and '30s:

> *Saving means the withdrawal of resources from the production of consumption goods and services to have enough for maintenance, expansion and improvement of the plant. Without such savings, the economy not only could not progress, but would stagnate. It would decline toward ultimate collapse. I am afraid that ever since Wesley Mitchell's* Business Cycles*, there has been a tendency to concentrate too much on the monetary expression of economic developments, and it has become reactionary to think in physical terms. But the physical facts are basic.*

It used to be a truism in economics that, given limited resources for production, saving has to decrease consumer spending in order to make a corresponding part of GDP available for capital investment. This, in fact, is the crucial physical fact about saving. From this macro perspective, saving out of current income is clearly indispensable for producing the capital goods that increase our incomes in the long run through higher capital investment and associated productivity growth.

Equating the rising house prices in the United States with saving reveals utter ignorance in macroeconomics, because the homeowners generally use the equity withdrawal through mortgage refinancing for higher consumer spending. Manifestly, the effect is precisely the opposite to that of saving. These homeowners really convert capital into consumption, which is a clear case of dissaving.

THE TRADE DEFICIT MOLOCH

We come to the huge U.S. trade deficit, America's other dangerous imbalance, now exceeding an annual rate of $700 billion. What are policymakers and economists saying about it? In general, they either discard it as a harmless phenomenon or even hail it as an emblem of superior economic growth.

General flat denial and the refusal of any need for treatment are the common results. Other customary

arguments are platitudes about the infallible benefits of globalization. Just as typically, there is not the slightest attempt to seriously weigh economic benefits and damages.

Basically, the U.S. trade deficit reflects a corresponding diversion of domestic spending away from domestic and toward foreign producers. To this extent, the latter enjoy an equivalent gain in revenue and profits. Conversely, U.S. producers suffer an equivalent loss of revenue and profits. Considering the sums involved, the negative implications for income and profit creation in the United States are immense.

In 2004, the U.S. current account deficit ballooned by $135.3 billion to an annual rate of $665.9 billion. This has to be seen against an increase of $731 billion in nominal GDP growth to $11,735 billion. Moreover, this income and profit drag is accelerating.

This persistent spending and income loss to foreign producers has grown to a size that currently diminishes U.S. GDP growth by a full percentage point. In order to prevent this from materializing, a more expansionary monetary policy to offset this inherent drag is necessary. This is the first problem.

In our view, the persistent attempt to offset the trade drag with an easier monetary policy is a Sisyphean task that is bound to fail disastrously in the longer run because the necessary monetary looseness simultaneously aggravates the trade deficit.

It is widely perceived that the U.S. monetary and fiscal policies of the last few years have been a great success. The usual gauge for this favorable assessment is the distinctly slower economic growth in Europe and Japan. But when compared with the vigor of past U.S. postwar recoveries, the present one stands out as unusually feeble, particularly when considered against the unprecedented policy stimulus.

THE MAIN VICTIM: U.S. MANUFACTURING

Yet far worse, though also flatly ignored, is the enormous structural damage to the U.S. economy through its trade deficit. As foreign trade occurs overwhelmingly in manufactured goods, this sector is the big loser. The unmitigated beneficiary of the Fed's monetary looseness, on the other hand, has been an overexpanding service sector.

This shift in the U.S. economy's structure, implicit to the soaring trade deficit, has troubling long-term repercussions, because the manufacturing sector plays an outstanding role in the growth process of industrial or industrializing countries:

1. Manufacturing and construction stand out for having high-paying jobs, in the United States in particular, while the gaining service sector has a very large component of low-paid jobs.
2. In industrialized and industrializing countries, manufacturing is the sector with the highest investment ratio for its production. Consequently, it plays a crucial role in determining the level of business capital investment in the economy as a whole. In essence, strong growth in capital investment is vital for self-sustaining economic growth.
3. Manufacturing governs the trade balance. A trade imbalance is always overwhelmingly an imbalance in the trade of manufactured goods. An export surplus fosters the growth of manufacturing; an import surplus depresses the sector. Over the past few years, the U.S. trade gap has grown to a size that cuts deeply into the substance of U.S. manufacturing.
4. The trade-exposed manufacturing sector implicitly bears the brunt of the damages impacting the U.S. economy from the soaring trade deficit. With a decline of almost 3 million jobs since 2000, the manufacturing sector accounts for virtually all of the job losses in the economy. Compared to past recoveries, almost 5 million jobs are missing. Real average hourly earnings were no higher in 2004 than they were in November 2001 the trough of the recession.

Basically, the U.S. economy's underperformance compared to past cyclical recoveries arises from the dramatic underperformance of manufacturing. The trade deficit is the great killer of profits, employment and investment in manufacturing. No change is in sight.

Fatally, the U.S. trade deficit does not stand still. It is increasingly aggravated by a diametric and growing divergence in manufacturing investment between Asian and American firms. Compared to 2000, U.S. fixed investment in industrial structures was down 55%, and industrial equipment down 5%, in the fourth quarter of 2004. In Asia, particularly in China, capital investment is growing at high double-digit rates.

This leaves us with the most important, and most puzzling, question of all: Why has the Fed's ultra-easy and ultra-cheap supply of money and credit been so effective in boosting consumer spending but so grossly ineffective in lifting business fixed investment?

There are two possible causes: existing excess capacities from past overinvestment or unsatisfactory profits or profit expectations. For us, the first assumption makes no sense in the face of the huge trade deficit. If idle competitive capacities existed, U.S. firms would employ them, increasing exports and reducing imports.

What, then, about business profits? Here, too, the answer is simple and categorical: If U.S. businesses saw satisfactory profits or profit prospects, they would unquestionably invest and produce. Obviously, these desired profits and profit prospects are missing.

For this unsatisfactory profit performance, we see two groups of causes. One group looms on the macro level and the other one on the micro level of corporate governance.

The most striking and most important example of the first group of profit-squeezing influences is America's trade deficit. It should be manifest to everybody that the massive diversion of domestic spending to foreign producers in the horrendous size of that deficit implies an equivalent massive drag on the revenues and profits of U.S. producers. Also consider that the money purchasing foreign goods comes largely from wages and salaries paid by American firms.

The second group of adverse influences on business profits may be more controversial. We see it in the obsessive fixation of American management and markets on immediately higher shareholder value. Lack of patience with slow profit creation through new capital investment has increasingly lured American firms to "purchase" quick expansion and profits through mergers and acquisitions.

Here again, critical macroeconomic thinking is completely missing. To the extent that mergers and acquisitions suppress new capital investment, this seriously damages economic growth and corporate profits in the aggregate. Capital investment — to be precise, growth in net capital investment — is vital for both.

BOGUS LIQUIDITY

The fact that the U.S. economy has outperformed Europe and Japan in the past few years has deluded most people about the sickly pattern of U.S. economic growth. For the reasons explained earlier — grossly understated inflation rates — the reported rates of real GDP growth rates are, first of all, grossly overstated.

More important, U.S. economic growth during the past few years has had two obviously unsustainable principal sources: first, rapidly inflating house prices; and second, a related, out-of-control consumer borrowing-and-spending binge.

We must admit to have conspicuously underestimated the staying power of the U.S. housing bubble. The recklessness of both borrowers and lenders has vastly exceeded our imagination.

Yet this does not change our principal view that the housing bubble — together with the bond and stock bubbles — will invariably implode in the foreseeable future, plunging the U.S. economy into a protracted, deep recession.

Whenever we say this, we are typically answered that this is impossible, because overabundant liquidity is sloshing around the U.S. and world markets. We do not buy this argument. Keep in mind that major economic and financial crises have always been preceded by apparent excess liquidity, which abruptly vanished with plunging asset markets. What is sloshing around in the U.S. and world markets is overwhelmingly borrowed liquidity, and that is, in reality, bogus liquidity.

In looking for liquidity, it is necessary to distinguish between two diametrically different kinds: liquidity

created by borrowing against inflating asset values and liquidity accumulated from saving out of current income. We see a great scarcity of the latter kind of liquidity, particularly in the United States, against an unprecedented overabundance of the former.

For us, one of the most important things to see about the U.S. economy is that in the virtual absence of any liquidity creation through saving from current income, the financial system and its level of asset prices have become completely dependent on endless, rampant financial leveraging. Last year, this required an atrocious credit expansion of $2.7 trillion.

Judging by their aggregate balance sheet, U.S. private households appear fairly liquid, but all this liquidity has accumulated through equity withdrawal from rising home prices, while spending keeps running ahead of current earnings. Consider that all that is needed to radically cut off this liquidity flow is for house price inflation to cease.

To get a rough idea of the potential horrendous impact on the U.S. economy and its asset markets if this happens, just ponder that U.S. private households went more than $1,000 billion into debt last year.

If this extraordinary source of finance dries up, which is certainly in sight, private households in the United States will abruptly face stringent illiquidity, forcing them to slash their spending and sell inflated assets. In due time, this will pull the rug out from under all U.S. asset markets.

BUSINESSES ON THE RETREAT

What about the liquidity of firms and their spending? We keep reading that U.S. businesses have considerably improved their balance sheets. From 2000–04, undistributed corporate profits piled up, rising from $130.2 billion to $272.3 billion.

That looks formidable, for sure. Taking a closer look, though, we discovered more negatives than positives. In a healthy economic environment, the business sector regularly runs a big deficit in capital investment spending over and above depreciations. In the United States, corporate liquidity has improved largely for a negative reason: cutting investment spending relative to rising depreciations.

Mergers, acquisitions and buying their own shares enjoy obvious preference on the part of management over investing in plant and equipment. In 2004, corporate spending on the former soared to $210 billion, just $5.5 billion shy of the 1998 record.

Along with the fact that corporate insiders have been selling their own shares en masse, this essentially suggests a general corporate reluctance to expand through organic capital investment. Looking for a reason, we see mainly one: unsatisfactory profit prospects.

The desirable way for corporations to liquefy their balance sheets is, of course, through retained earnings or equity issuance. Retained earnings have been soaring in the aggregate. But by taking a close look at details available through 2003, we made some unpleasant discoveries.

One is that U.S. nonfinancial firms get the bulk of their undistributed profits from their foreign subsidiaries. Since 2000, this contribution has risen from $116.3 billion to $151.4 billion, while domestically earned undistributed profits have edged up from $2.4 billion to a mere $27 billion. For financial firms, retained earnings soared from $11.7 billion to $87.5 billion.

Most disturbing of all, however, is the distribution of domestically earned undistributed profits, for which data are available only through 2003. Not surprisingly, the conspicuous big negative contributors are manufacturing and information.

In 2003, the undistributed domestic profits of manufacturing firms were deep in the red, at $61.9 billion, and those of the information sector were down $25.7 billion, meaning that the firms spent more on dividends than they earned domestically. In other words, many manufacturing firms mainly earn their profits abroad. Recall that foreign firms also have miserable earnings on their direct investments in the United States.

It is argued that stronger corporate balance sheets will spur a stronger investment recovery. But the whole of that improvement owes to investing less relative to the flow of depreciations. In 2000, U.S. firms spent $310.4 billion on capital investment in excess of the cash flow on capital investment. Last year, despite all the tax incentives for investment, this so-called financial gap amounted to $27.5 billion. This rather looks like an investment slump.

LOOKING FOR "THE SINGLE EVENT…"

The just-published *Global Financial Stability Report* of the International Monetary Fund starts with unreserved praise that *"the resilience of the global financial system has further improved in the past six months, largely because of solid global economic growth, buoyant financial markets, and continued improvement in the balance sheets of the corporate, financial, and household sectors in many countries."*

Having briefly extolled this, the next, much longer chapter of the report starts:

> *If history is any guide, the single most important risk factor for financial markets in good times is complacency… The combination of low risk premiums, complacency and untested elements of risk management systems dealing with complex financial instruments could ultimately become hazardous to financial markets… At present, it is not easy to see which single event, short of a "major devastating geopolitical incident or a terrorist attack" as highlighted in the September 2004 issue of the* Global Financial Stability Report*, could possibly trigger a sharp and abrupt reversal of this positive assessment.*

Needless to say, the complacency prevailing in many countries has its root cause in the illusion of tremendous wealth and liquidity creation through rapidly inflating asset prices, house prices in particular. For obvious reasons, Japan and Europe (except England) do not share this complacency. It shocks us that the IMF hails this as remarkable balance sheet improvement in the face of exponential debt growth.

We think it is time now, as the IMF suggests, to look for *"the single event which could possibly trigger a sharp and abrupt reversal of this positive assessment."* Stating this, our eyes are particularly on the U.S. economy, for two obvious reasons. One is that U.S. consumer spending has been the world economy's main locomotive in the past four years; the other one is that the United States is also the home of the greatest complacency about economic performance and prospects.

THE GREAT POLICY FAILURE

How strong is the U.S. economy really? The consensus, without question, regards it as the Hercules among industrial countries, pulling the whole world economy. Their measure is the real GDP growth rates of the last few years. Moreover, the experience of 2001 — an unusually weak recession despite the stock market's bust — has created tremendous faith in the economy's ability to cope with shocks. In its recent issue, Grant's Interest Rate Observer states, *"The United States is the world's greatest net beneficiary of confidence."*

As our readers know, our approach is radically different. We regard the popular, favorable comparisons with Europe and Japan as a dubious device to detract from the fact that this U.S. economic recovery has performed very poorly in comparison to past postwar recoveries.

The final failure of the implemented policies shows, however, in the extremely skewed pattern of GDP growth: Unprecedented excesses in consumer borrowing and spending have escalated at the expense of saving, investment and foreign trade.

All along, it was taken for granted that with the powerful monetary and fiscal demand stimulus, the normal dynamics of job and income creation would promptly kick in. They have not, for the reason explained: serial massacre of the manufacturing sector through the growing trade deficit.

As to job and income growth, we have to warn that the shockingly weak number of 110,000 new jobs in

March was in reality a gross exaggeration, because fully 179,000 were created by a stroke of the pen through the dubious "net birth/death" computer model. Although wage growth has modestly accelerated, it lags the rising inflation rate.

U.S. SLUMP

There can no longer be any doubt that the U.S. economy has joined the global downturn with a vengeance. Taking the complacent consensus completely by surprise, its instant comforting explanation is a "soft patch." Another typical refrain is that the U.S. economy is nevertheless doing better than the European and the Japanese economies.

As bad as the GDP numbers for the first quarter appear, upon closer review they were short of disastrous. Inventory building, largely unintended certainly, accounted for 1.21 percentage points, or close to 39%, of the reported GDP growth. Final sales (GDP minus inventory growth) rose just 1.9% at annual rate. Not annualized this is a bit less than 0.5%. The trade deficit slashed growth by 1.49 percentage points at annual rate. This weakness in spending was compounded by a jump in the GDP deflator from 2.3% to 3.3%.

Also highly important, the report dashed any hopes that rising business investment would offset slowing consumer spending. Growth of overall business investment slumped from 14.5% in the prior quarter to just 4.7%. Reported recent shipments are negative.

CONCLUSIONS:

To emphasize the key points about the U.S. economy: profligate monetary and fiscal policies have flatly failed to generate self-sustaining economic growth. A second and most important point is that the U.S. economy — look at savings, the trade and the budget deficit and record debt levels — is today in incomparably worse shape than in 2000.

These structural problems are now severely compounded by accelerating inflation. In March, rising inflation slashed an increase in disposable income by 0.5% to just zero in real terms. An increase in personal consumption expenditures by 0.6% shrank to just 0.1% after inflation-adjustment. This is actual stagflation.

All this current talk of a mere oil-induced "soft patch" is another self-deception. The rising oil price is a minor cause of the economy's slowdown in comparison to the whole variety of outsized growth-impairing imbalances.

While Europe and Japan appear stuck with slow economic growth, the greatest hazards and the greatest risk are unquestionably lurking in the U.S. economy and its financial system.

Investors should avoid any risk. There are times when avoiding losses is the predominant task.

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